

# UNITED STATES ANTIFRAUD JURISDICTION OVER TRANSNATIONAL SECURITIES TRANSACTIONS: MERGER OF THE CONDUCT AND EFFECTS TESTS

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## 1. INTRODUCTION

This Article discusses a major recent development in the law governing circumstances under which foreign corporations and individuals may be subjected to the jurisdiction of U.S. courts in lawsuits alleging violations of the antifraud provisions of the federal securities laws.<sup>1</sup>

Traditionally, U.S. courts have considered two separate tests to determine whether they had the power to decide federal securities fraud claims involving transnational transactions: the “conduct test” and the “effects test.” The *conduct* test focuses on conduct of the defendants that occurred in the United States, whereas the *effects* test focuses on the effect within the United States of conduct that occurred outside the United States.<sup>2</sup>

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<sup>1</sup> This Article is a general review of the subjects covered and does not constitute an opinion or legal advice, and reflects solely the views of the author.

<sup>2</sup> See *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1333-39 (2d Cir. 1972) (establishing the conduct test); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208-09 (2d Cir.) (establishing the effects test), *rev'd en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969) and cases cited therein. For commentary, see Norimasa Murano, *Extraterritorial Application of the Antifraud Provisions of the Securities Exchange Act of 1934*, 2 INT'L TAX & BUS. L. 298 (1984); Kellye Y. Testy, *Comity and Cooperation*:

In an important new development, the court most responsible for developing this area of the law declared for the first time that elements of the conduct and effects tests should be combined to determine whether a U.S. court should exercise its jurisdiction and apply U.S. law.<sup>3</sup> This development is both theoretically and procedurally significant because activities that previously may not have satisfied either test, and which therefore may have resulted in a finding of no jurisdiction, now may support jurisdiction under the combined test.

Because the combined test always considers effects within the United States, the accelerating globalization of securities markets<sup>4</sup> makes it particularly important for foreign entities raising capital in global markets to apprise themselves of this new development,<sup>5</sup> and thereby appreciate the nature of the conduct that may subject them to the jurisdiction of U.S. courts in a federal securities antifraud lawsuit.<sup>6</sup>

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*Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994); Joel P. Trachtman, *Recent Case*, 84 AM. J. INT'L L. 755 (1990); John W. Hamlin, Comment, *Exporting United States Law: Transnational Securities Fraud and Section 10(b) of the Securities Exchange Act of 1934*, 3 CONN. J. INT'L L. 373 (1988); Gregory K. Matson, Note, *Restricting the Jurisdiction of American Courts Over Transnational Securities Fraud*, 79 GEO. L.J. 141 (1990).

<sup>3</sup> *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 124 (2d Cir. 1995) (decided May 15, 1995, as amended May 31 and June 1, 1995).

<sup>4</sup> According to a November 1, 1994, Securities Industry Association research department table titled "United States net purchases of foreign securities," U.S. investors acquired a record amount of foreign equities and bonds during each of the last three years: \$47 billion in 1991, \$50 billion in 1992, and \$124 billion in 1993. See also DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 32 (1994) (predicting that "global trading will continue to grow," and that "[c]apital will move more easily around the world").

<sup>5</sup> Recently liberalized SEC rules and regulations that may restrict the circumstances under which a foreign issuer must register and file reports in the United States generally do not restrict securities fraud lawsuits in U.S. courts. See, e.g., *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 986 (2d Cir.) ("It is elementary that the antifraud provisions of the federal securities laws apply to many transactions which are neither within the registration requirements nor on organized U.S. markets."), cert. denied, 423 U.S. 1018 (1975).

<sup>6</sup> The burden and expense of defending these lawsuits can be devastating for those with minimal U.S. contacts, and may cause the

### 1.1. *Subject Matter Jurisdiction*

Parties often file securities fraud suits in U.S. federal courts after defaults in stock sale, financing, and other securities transactions that took place entirely or almost entirely outside the United States. At the outset of a suit involving international fraud, a federal court often must consider whether it is appropriate for that court to exercise jurisdiction over foreign defendants. The threshold question is whether the court has jurisdiction over the subject matter of the claim.<sup>7</sup> If the court lacks subject matter jurisdiction, it then lacks power to decide the dispute and must dismiss the case.<sup>8</sup>

Section 27 of the Securities Exchange Act of 1934 ("1934 Act") confers subject matter jurisdiction exclusively to U.S. district courts over actions brought to enforce antifraud provisions such as Section 10(b) of the 1934 Act and SEC

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settlement of completely unfounded claims. For example, establishing in a specific instance that SEC antifraud provisions do not apply outside the United States may require a full trial on the merits. *See, e.g., Venture Fund (Int'l) N.V. v. Willkie Farr & Gallagher*, 418 F. Supp. 550, 555 (S.D.N.Y. 1976) (observing that testimony and other detailed evidence are often necessary when deciding jurisdictional questions in securities fraud cases); *cf. Fidenas AG v. Compagnie Int'l Pour L'Informatique CII Honeywell Bull S.A.*, 606 F.2d 5, 7 n.2 (2d Cir. 1979) ("[T]his is one of those rare cases in which the question of subject matter jurisdiction is best decided at the pleading and affidavit stage."). *But see MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 176 (5th Cir. 1990) and cases cited therein (finding that after an evidentiary hearing on the jurisdictional issue alone, the court needed no trial on the merits in order to resolve the subject matter jurisdiction question).

<sup>7</sup> *See, e.g., AVC Nederland B.V. v. Atrium Inv. Partnership*, 740 F.2d 148, 153 (2d Cir. 1984) ("[E]very one of this court's seven major decisions regarding the application of the securities laws to transactions carried out in part in the United States and in part abroad has regarded the issue as one of subject-matter jurisdiction.").

<sup>8</sup> If a U.S. court rules that it has subject matter jurisdiction and thus the authority to decide the matter, it still may dismiss the action under discretionary doctrines such as comity, which gives effect to the laws of another country, not because of an obligation to do so, but out of deference and respect, and *forum non conveniens* whereby courts decline jurisdiction in favor of another forum for the convenience of the parties and the interest of justice. *See, e.g., Allstate Life Ins. Co. v. Linter Group Ltd.*, 994 F.2d 996, 998-1002 (2d Cir.) (discussing application of and policies behind comity and *forum non conveniens*), *cert. denied*, 114 S. Ct. 386 (1993).

Rule 10b-5.<sup>9</sup> Section 27 is silent, however, on the extent to which this power extends to individuals, entities, and acts outside the United States.<sup>10</sup> As a result, the law on extraterritorial subject matter jurisdiction in securities fraud actions has evolved through a series of reported court decisions.<sup>11</sup> These decisions articulate two tests for extraterritorial subject matter jurisdiction in securities antifraud actions: the effects and conduct tests.<sup>12</sup> Courts have adopted the same tests for Commodity Exchange Act antifraud actions.<sup>13</sup>

## 1.2. The Effects Test

The effects test focuses on the effect within the United States of conduct that took place outside the United States. This test has its roots in the foreign relations legal concept that a state possesses jurisdiction over a person who fires a gun from outside its borders and causes injury to one of its citizens within its borders.<sup>14</sup>

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<sup>9</sup> See 15 U.S.C. § 78a-111 (1994). Section 27 confers exclusive jurisdiction to U.S. district courts over all "actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa (1994).

<sup>10</sup> See *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir.), *cert. denied*, 502 U.S. 1005 (1991).

<sup>11</sup> Early cases held that Section 27 had no extraterritorial application. See, e.g., *Ferraioli v. Cantor*, Fed. Sec. L. Rep. (CCH) ¶ 91,615 (S.D.N.Y. 1965). A U.S. court first held the 1934 Act to have extraterritorial application in *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev'd en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969). Many decisions refining and expanding this topic followed. See discussion *infra* sections 2 and 3.

<sup>12</sup> Subject matter jurisdiction standards may vary among the circuit courts. See *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30-31 (D.C. Cir. 1987); *MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 174-75 (5th Cir. 1990). The formulations used in the decisions to describe the standards, however, are so broad, differ so slightly, and depend so heavily on fact, that the standards may be viewed as substantively the same. See discussion *infra* section 3.

<sup>13</sup> 7 U.S.C. § 1 (1995). See, e.g., *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983); *Tamari v. Bache & Co. (Leb.) S.A.L.*, 730 F.2d 1103, 1107-08 (7th Cir.), *cert. denied*, 469 U.S. 871 (1984).

<sup>14</sup> See *Strassheim v. Daily*, 221 U.S. 280, 285 (1911) ("Acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a State in punishing the cause of the harm as if he had been present at the effect, if the State should succeed in

To analyze the analogous situation in the context of securities fraud, U.S. courts have engaged in the fiction of determining what Congress intended, specifically, “whether Congress would have wished the precious resources of the [U.S.] courts to be devoted to such transactions.”<sup>15</sup> This reasoning led to the articulation of the effects test.

Under the effects test, a U.S. court has jurisdiction where illegal activity abroad causes a “substantial effect” within the United States.<sup>16</sup> In applying this “substantial effect” test, and generally in considering the question of federal jurisdiction in transnational securities cases, no

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getting him within its power.”) (citations omitted). *See also* RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §18 (1965). According to the *Restatement (Second)*:

A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either

- (a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or
- (b) (i) the conduct and its effect are constituent elements of activity to which the rule applies; (ii) the effect within the territory is substantial; (iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

*Id.*

<sup>15</sup> *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir.) (quoting *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975)), *cert. denied*, 502 U.S. 1005 (1991); *see also Psimenos*, 722 F.2d at 1045.

<sup>16</sup> *See Alfadda*, 935 F.2d at 478; *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 261-62 (2d Cir.), *modified on other grounds*, 890 F.2d 569 (2d Cir.), *cert. dismissed*, 492 U.S. 939 (1989); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975); *see also Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 989 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975) (requiring injury to purchasers or sellers “in whom the United States has an interest”); *IIT v. Cornfeld*, 619 F.2d 909, 917 (2d Cir. 1980) (stating that the lower court cited *Bersch* as holding that an “unparticularized deleterious effect on the [U.S.] economy” is insufficient); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208-09 (2d Cir.) (finding impairment of domestic share values to be a “sufficiently serious effect”), *rev’d en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

single factor is necessarily dispositive.<sup>17</sup> Nevertheless, guidance on what courts consider a "substantial effect" may be gleaned from a review of leading effects test cases, including the factors these cases identify as tending to support or not support subject matter jurisdiction.

### 1.3. The Conduct Test

The conduct test focuses on conduct of defendants that took place within the United States. A court has subject matter jurisdiction under the conduct test where "particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad."<sup>18</sup> This

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<sup>17</sup> See *MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 175 (5th Cir. 1990); *Cornfeld*, 619 F.2d at 918; *Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 414 (8th Cir. 1979); *Drexel Firestone*, 519 F.2d at 986; *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515, 523-24 n.14 (8th Cir. 1973).

<sup>18</sup> *Alfadda*, 935 F.2d at 478; see *Drexel Firestone*, 519 F.2d at 992-93; see also *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 33 (D.C. Cir. 1987) (finding that fraudulent statements or misrepresentations originating in the United States and directly causing harm to plaintiff may suffice to establish jurisdiction); *AVC Nederland B.V. v. Atrium Inv. Partnership*, 740 F.2d 148, 153-54 (2d Cir. 1984) (stating that activity in the United States involving U.S. securities may suffice to establish jurisdiction); *Tamari v. Bache & Co. (Leb.) S.A.L.*, 730 F.2d 1103, 1108 (7th Cir.), *cert. denied*, 469 U.S. 871 (1984) (deeming conduct in the United States material to successful completion of alleged scheme sufficient to establish jurisdiction); *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 424-25 (9th Cir. 1983) (adopting test of whether conduct in the United States was significant, material, and furthered the fraudulent scheme, and was not merely preparatory); *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1046 (2d Cir. 1983) (requiring conduct material to completion of fraud to have occurred in the United States); *Cornfeld*, 619 F.2d at 920-21 ("[W]hether [U.S.] activities 'directly' caused losses to foreigners depends not only on how much was done in the United States but also on how much . . . was done abroad."); *Continental Grain*, 592 F.2d at 415 (supporting the requirement that at least some activity designed to further a fraudulent scheme occur in United States); *Fidenas AG v. Compagnie Internationale Pour L'Informatique CII Honeywell Bull S.A.*, 606 F.2d 5, 10 (2d Cir. 1979) (finding no jurisdiction over transactions that were "on any view" predominantly foreign); *SEC v. Kasser*, 548 F.2d 109, 111-12 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977) (finding that significant conduct in the United States which formed part of defendants' scheme is sufficient to establish jurisdiction); *Travis*, 473 F.2d at 524 (stating that significant conduct in the United States related to the alleged violations is sufficient to establish jurisdiction); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334-35, 1337 (2d Cir. 1972) (finding that

test is rooted in the foreign relations legal principle that a state may assert jurisdiction based on conduct within its territory.<sup>19</sup> Courts traditionally have relied on the conduct test as an alternative to the effects test when the plaintiffs were foreign, and, consequently, the effects within the United States were insufficient to support subject matter jurisdiction under the effects test.<sup>20</sup> The theories of fraud pleaded in the complaint are critical in establishing jurisdiction under the conduct test because the definition of the fraud impacts the analysis of where the fraud occurred.<sup>21</sup>

In developing the notion that conduct alone could support subject matter jurisdiction, courts reasoned that Congress would not have wanted the United States to be used as a vehicle for the export of fraud.<sup>22</sup> Similar to the effects test, the conduct test leads courts to find that they lack jurisdiction when conduct in the United States is so minimal that Congress would not have desired the "precious resources of U.S. courts and law enforcement agencies" to be devoted to a suit based on such negligible conduct.<sup>23</sup>

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"significant conduct" in the United States consisting of "abundant" or "substantial" misrepresentations is sufficient to establish jurisdiction); *Vencap*, 519 F.2d at 1018 (requiring fraudulent acts to establish jurisdiction, and finding that the failure to prevent fraudulent acts in foreign countries or merely preparatory acts is insufficient "where the bulk of the activities was performed in foreign countries").

<sup>19</sup> See *Leasco*, 468 F.2d at 1334, which discusses RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §17 at 45 (1965). According to the *Restatement*:

A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and

(b) relating to a thing located, or a status or other interest localized, in its territory.

*Id.* §17.

<sup>20</sup> See, e.g., *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir.), on remand, 411 F. Supp. 1094, 1107-09 (S.D.N.Y. 1975).

<sup>21</sup> *Vencap*, 519 F.2d at 1011-14, 1018 (identifying five separate fraud theories and noting that jurisdiction could likely be extended only under two of the theories).

<sup>22</sup> See *id.* at 1017.

<sup>23</sup> *Fidenas AG v. Compagnie Int'l Pour L' Informatique CII Honeywell Bull, S.A.*, 606 F.2d 5, 10 (2d Cir. 1979), and cases cited

Like the effects test, guidance on the nature of U.S. activity supporting conduct test jurisdiction may be extracted from a review of the factual situations and rulings made by courts addressing the issue.

## 2. THE MERGER OF THE CONDUCT AND EFFECTS TESTS

In *Itoba Ltd. v. Lep Group PLC*, the Second Circuit for the first time expressly merged the elements of the conduct and effects tests.<sup>24</sup> The Second Circuit has been the court primarily responsible for originating and developing these tests.<sup>25</sup>

### 2.1. Conduct and Effects Elements

In *Itoba*, *Itoba Ltd.* ("Itoba") sued *Lep Group PLC* ("Lep"), a London-based holding company with some fifty subsidiaries in thirty countries, a true international conglomerate.<sup>26</sup> Lep's ordinary shares were registered in the United Kingdom and mainly traded on the London Exchange.<sup>27</sup> For approximately 9.4% of its ordinary shares, Lep also issued American Depository Receipts ("ADRs") in the United States, which were traded on the National Association of Securities Dealers Automated Quotation System ("NASDAQ").<sup>28</sup> These actions subjected Lep to the reporting and disclosure requirements of U.S. securities laws. Lep therefore filed annual reports on Form 20-F with the U.S. Securities and Exchange Commission ("SEC").<sup>29</sup>

A.D.T. Limited ("ADT") was a transnational holding

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therein.

<sup>24</sup> *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 124 (2d Cir. 1995); see also Deborah Pines, *Foreign Securities Fraud Suit Reinstated on Appeal*, N.Y. L.J., May 17, 1995, at 1 (stating that according to *Itoba's* counsel, the decision is the first to say conduct and effects tests should not be considered in isolation).

<sup>25</sup> See *MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 173-74 (5th Cir. 1990); *Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 413-14 (8th Cir. 1979).

<sup>26</sup> See *Itoba*, 54 F.3d at 120.

<sup>27</sup> See *id.*

<sup>28</sup> See *id.*

<sup>29</sup> See *id.* at 120-21.



company based in Bermuda with substantial U.S. ownership.<sup>30</sup> Its shares were listed on the New York Stock Exchange and approximately 50% of its shareholders of record resided in the United States.<sup>31</sup> ADT had a small ownership interest in Lep.<sup>32</sup>

In deliberating over whether it should increase its Lep ownership, ADT evaluated: (1) Lep's 1988 Form 20-F filed with the SEC, (2) Lep's U.K. annual reports, (3) Lep's shareholder register, (4) Lep's broker reports, and (5) an analysis prepared by an investment bank based on the 1988 Form 20-F.<sup>33</sup> Based on this information, ADT decided to acquire Lep.<sup>34</sup> ADT increased its Lep holdings by making anonymous purchases on the London Stock Exchange through its offshore subsidiary, Itoba.<sup>35</sup> With ADT funding Itoba's purchases,<sup>36</sup> Itoba acquired over 37 million ordinary shares for approximately \$114 million.<sup>37</sup> Before ADT could complete its planned acquisition, however, Lep disclosed a series of business reversals that caused the value of Lep's shares to decline by 97%, and caused the value of Itoba's holdings in Lep to decline by nearly \$111 million.<sup>38</sup>

Itoba alleged that Lep and its officers had committed federal securities fraud, and sued them in a U.S. district court.<sup>39</sup> According to Itoba, Lep made high-risk investments and engaged in speculative business ventures without adequately informing the investing public in its SEC filings.<sup>40</sup> Itoba maintained that it would not have purchased Lep's stock at artificially inflated prices had

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<sup>30</sup> See *id.* at 120.

<sup>31</sup> See *id.*

<sup>32</sup> See *id.*

<sup>33</sup> See *id.* at 121.

<sup>34</sup> See *id.*

<sup>35</sup> See *id.*

<sup>36</sup> See *id.*

<sup>37</sup> See *id.*

<sup>38</sup> See *id.*

<sup>39</sup> See *id.*

<sup>40</sup> See *id.*

these matters been disclosed properly.<sup>41</sup>

## 2.2. Combined Test Applied

On defendant's motion for summary judgment, the district court dismissed Itoba's claims for lack of subject matter jurisdiction. Itoba appealed and the Second Circuit reversed and remanded the case for a new trial.<sup>42</sup>

In finding subject matter jurisdiction, the Second Circuit for the first time stated that applicable principles of both the conduct and effects tests ought to be combined, observing that "[t]here is no requirement that these two tests be applied separately and distinctly from each other."<sup>43</sup> The court explained that "an admixture or combination of the two often gives a better picture of whether there is sufficient U.S. involvement to justify the exercise of jurisdiction by an [U.S.] court."<sup>44</sup> Accordingly, it held that "a sufficient combination of ingredients of the conduct and effects tests is present in the instant case to justify the exercise of jurisdiction by the district court."<sup>45</sup>

With respect to elements of the conduct test, the Second Circuit noted that LEP could be held liable under a theory of derivative reliance because the contents of Lep's Form 20-F, which Lep filed with the SEC, led to investment by Itoba.<sup>46</sup> Specifically, Itoba approved the acquisition of Lep securities at the direction of its parent, ADT, which had relied in turn on its analysis of Lep's Form 20-F and its investment banker's report based on the Form 20-F.<sup>47</sup> The court held that a "direct linkage" between the price of the ADRs (each representing five ordinary shares) and the price of the ordinary shares listed in London rendered it inconsequential that the SEC filings pertained to ADRs and not to ordinary shares.<sup>48</sup> The court found subject matter jurisdic-

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<sup>41</sup> *See id.*

<sup>42</sup> *See id.* at 125.

<sup>43</sup> *Id.* at 122.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.* at 124.

<sup>46</sup> *See id.* at 122

<sup>47</sup> *See id.*

<sup>48</sup> *See id.* at 123.

tion, concluding that SEC filings, in connection with ADRs, may be a predicate for subject matter jurisdiction over purchases of other company securities when the filings include substantial misrepresentations that would cause reliance by reasonable investors in purchasing or selling those other securities.<sup>49</sup>

With respect to elements of the effects test, the court stated that continued uncorrected nondisclosure in LEP's SEC filings, which were prepared outside the United States, had a deleterious effect on thousands of ADT shareholders in the United States. Moreover, the court concluded that the conduct producing such effects could not correctly be described as incidental or preparatory.<sup>50</sup> The court further noted that ADT's stock was traded on the New York Stock Exchange, that approximately 50% of its shares were held in the United States, and that ADT's shareholders ultimately would bear losses in excess of \$100 million in shareholders' equity because ADT had financed the purchase of Lep's shares.<sup>51</sup> Based on the foregoing, the court concluded that the case presented a sufficient combination of factual elements satisfying the conduct and effects tests to justify the exercise of jurisdiction.<sup>52</sup>

### 3. ANALYSIS

Before *Itoba*, courts repeatedly allowed plaintiffs to establish subject matter jurisdiction by meeting the requirements of *either* of the two tests.<sup>53</sup> The *Itoba* court's *combi-*

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<sup>49</sup> See *id.*

<sup>50</sup> See *id.* at 124.

<sup>51</sup> See *id.*

<sup>52</sup> See *id.*

<sup>53</sup> See *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir.), *cert. denied*, 502 U.S. 1005 (1991); *MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 174 (5th Cir. 1990); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30 (D.C. Cir. 1987); *Tamari v. Bache & Co. (Leb.) S.A.L.*, 730 F.2d 1103, 1107 (7th Cir.), *cert. denied*, 469 U.S. 871 (1984) (extending the tests to a case arising under the Commodity Exchange Act); *Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 416-17 (8th Cir. 1979); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985-86 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1016-17 (2d Cir.), *on remand*, 411 F. Supp. 1094 (S.D.N.Y. 1975). *But see Selzer v. Bank of Bermuda, Ltd.*, 385 F. Supp. 415, 418 (S.D.N.Y.

nation of the two tests thus seems to represent a notable departure from established authority.

In practical application, however, clear boundaries between the tests were not always easily perceptible. For example, courts have used activities arguably constituting conduct in performing an effects-test analysis.<sup>54</sup> This is consistent with the established view that the presence or absence of any single factor considered significant in other cases is not necessarily dispositive in establishing subject matter jurisdiction in a suit based on transnational securities fraud.<sup>55</sup> It is necessary, therefore, to examine leading decisions in order to gauge whether and to what extent *Itoba* modifies the substance of existing law.

Consideration of leading cases prior to *Itoba* containing factual elements relevant to both conduct and effects tests reveals that in two decisions, the tests were combined to some degree. Additionally, a review of these cases indicates that even in decisions that purported to rely upon only one of the two tests, each element of both tests had a bearing on whether courts were likely to exercise subject matter jurisdiction. Finally, previous decisions which contained factual elements pertinent to only one test and where the court relied only upon that test present strong evidence either for or against the exercise of jurisdiction under that test. This evidence supports the proposition that in mixed conduct and effects fact patterns in decisions preceding *Itoba*, courts have examined elements of both tests where necessary to achieve a reasonable result. Accordingly, *Itoba* seems to be a natural development of the case law and does not represent a major substantive change. It is an explicit recognition that the great variety found in fact patterns — from pure conduct through mixtures of conduct and effects to pure effects — renders the application of a merged test

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1974) (an early district court decision holding that both tests must be satisfied to establish subject matter jurisdiction).

<sup>54</sup> See *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 262 (2d Cir.), modified on other grounds, 890 F.2d 569 (2d Cir.), cert. dismissed, 492 U.S. 939 (1989) (establishing subject matter jurisdiction by finding that the transmittal of documents to U.S. citizens by British nominees, as required by British law, is an "effect").

<sup>55</sup> See cases cited *supra* note 17.

more practical and just.

### 3.1. *Prior Leading Cases Combining Elements of Both Conduct and Effects Tests*

#### 3.1.1. *Express Consideration of Combined Elements*

Although the Second Circuit did not create a general rule, it expressly combined elements of the conduct and effects tests in two leading decisions which preceded *Itoba*.

##### 3.1.1.1. *Purchaser Listed on a Single Exchange and Substantial Misrepresentations*

The seminal *Leasco Data Processing Equipment Corp. v. Maxwell* decision, which established the conduct test, invoked subject matter jurisdiction because of “substantial misrepresentations” made in the United States.<sup>56</sup> The misrepresentations — consisting of statements made at several meetings, written financial information, and the execution of an agreement<sup>57</sup> — induced a U.S. corporation to purchase foreign securities worth \$22 million on the London Stock Exchange through a wholly owned foreign subsidiary.<sup>58</sup> The foreign subsidiary had raised cash for the purchase by selling debenture and note offerings unconditionally guaranteed by the U.S. parent to foreigners.<sup>59</sup> The court expressed doubt that the resulting adverse effect on the single U.S. purchaser by itself would suffice to invoke subject matter jurisdiction, but held that the company’s misconduct in the United States “tipped the scales” in favor of asserting subject matter jurisdiction.<sup>60</sup> Thus, although the decision did not focus on this aspect of the analysis and did not enunciate a general rule, the

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<sup>56</sup> *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1337 (2d Cir. 1972).

<sup>57</sup> *See id.* at 1331-35.

<sup>58</sup> *See id.* at 1332.

<sup>59</sup> *See id.*

<sup>60</sup> *Id.* at 1337; cf. *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983) (stating, in a suit brought under the Commodity Exchange Act, that “[t]he conduct test does not center its inquiry” on the effect on domestic investors or markets, which suggests that some effects tests elements may be considered as well) (emphasis added).

Second Circuit appears to have combined elements of both tests in its analysis of transnational securities fraud more than two decades before *Itoba*.

3.1.1.2. *U.S. Underwriting of a Foreign Offering and Generalized Adverse Effects*

The Second Circuit's decision in *Bersch v. Drexel Firestone, Inc.* also expressly merged elements of the conduct and effects tests.<sup>61</sup> The court held that conduct related to organizing and structuring an offering in the United States, the hiring of New York law and accounting firms by an underwriter, meetings with an issuer, review of issuer operations, preliminary discussions on underwriting commissions and discounts, work on the prospectus, and opening accounts for proceeds of the underwriting, taken together still were insufficient conduct to invoke federal securities laws, at least where a foreign source issued the prospectus for the sale of foreign securities not offered in the United States.<sup>62</sup> The court also concluded that general adverse effects of the collapse of the foreign issuer in the United States, including the erosion of investor confidence in U.S. underwriters and the difficulties of U.S. corporations seeking to raise capital abroad, were insufficient to invoke federal jurisdiction.<sup>63</sup> The court then combined the two tests, observing that "we do not think that a combination of the [two foregoing conduct and effects elements], neither sufficient in itself, supports a result different from that which would be proper if each subsisted alone."<sup>64</sup>

Moreover, the *Bersch* decision analytically combined the conduct and effects tests in its holding. According to *Bersch*, the antifraud provisions of the federal securities laws:

- (1) Apply to losses from sales of securities to Americans resident in the United States whether or not

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<sup>61</sup> See *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 989-90 (2d Cir.), cert. denied, 423 U.S. 1018 (1975).

<sup>62</sup> See *id.* at 985 n.24., 987-90.

<sup>63</sup> See *id.* at 987-88.

<sup>64</sup> *Id.* at 989-90.

acts (or culpable failures to act) of material importance occurred in this country; and  
(2) Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but  
(3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.<sup>65</sup>

This sliding scale test inextricably links conduct and effects test elements because it requires more conduct when there is less effect on the United States and its citizens, and vice versa.<sup>66</sup>

### 3.1.2. *Implicit Consideration of Combined Elements*

In the following decisions, courts described conduct and effects elements which supported subject matter jurisdiction under a combined analysis, but then found jurisdiction under only one of the two tests. The inclusion of facts supporting jurisdiction under the test *not* relied on — which would be superfluous if the tests truly were separate — suggests that the courts found these facts material to the jurisdictional analysis.<sup>67</sup> These decisions indicate that conduct and effects test elements, considered together, have influenced decisions on subject matter jurisdiction.

#### 3.1.2.1. *U.S. Tender Offer, Material Omission, and Dilution of U.S. Shareholdings*

In *Schoenbaum v. Firstbrook*, an important early

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<sup>65</sup> *Id.* at 993.

<sup>66</sup> *See id.*; see also *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983) (stating that *Bersch* “linked the relative importance of the necessary conduct within the United States to the citizenship and residence of the purchasers of securities”).

<sup>67</sup> Where circumstances permitted, plaintiffs briefing the existence of subject matter jurisdiction presumably argued that it arose under both tests in order to place all favorable facts before the court.

decision which helped to establish the effects test, a foreign corporation made a tender offer in both the United States and Canada to obtain control of a Canadian corporation that had registered its stock with the SEC and that traded its stock on exchanges in the United States and Canada.<sup>68</sup> The foreign corporation and its affiliates then allegedly purchased treasury shares of the Canadian corporation while they possessed information about an undisclosed favorable development which would have increased the value and purchase price of the shares.<sup>69</sup> The corporation's refusal to disclose details of the development in either Canada or the United States<sup>70</sup> adversely affected remaining U.S. shareholders by diluting their shares more than if the favorable news had been announced.<sup>71</sup>

The Second Circuit held that this effect supported subject matter jurisdiction.<sup>72</sup> The decision did not purport to rely on conduct in the United States, which consisted of the foreign company's tender offer in the United States for shares of the Canadian company, and the foreign company's failure to disclose a material corporate development in the United States and elsewhere after it acquired the Canadian company.<sup>73</sup> Although not expressly relied on in the decision, this conduct in the United States certainly appears to justify effects test jurisdiction, and arguably helped "tip the scales" in favor of jurisdiction.<sup>74</sup>

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<sup>68</sup> See *Schoenbaum v. Firstbrook*, 405 F.2d 200, 204 (2d Cir.), *rev'd en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

<sup>69</sup> See *id.* at 205.

<sup>70</sup> See *id.* at 206.

<sup>71</sup> See *id.* at 208-09. Had the news been announced, the resulting higher price would have caused less treasury shares to be sold for the same proceeds. *Id.*

<sup>72</sup> See *id.*

<sup>73</sup> See *id.*

<sup>74</sup> *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1337 (2d Cir. 1972). See text accompanying notes 56-60.



3.1.2.2. *U.S. Company Acquires Foreign Company and the Presence of Adverse Effects on Exchange-Listed Securities*

The Ninth Circuit found effects test subject matter jurisdiction where the effect of a foreign transaction involving securities of a U.S. corporation listed on a U.S. national exchange adversely affected U.S. buyers, sellers, and holders of the securities.<sup>75</sup> In *Des Brisay v. Goldfield Corp.*, the court described extensive U.S. activity that supported conduct test jurisdiction without any conduct test analysis.<sup>76</sup> The foreign transaction at issue was an exchange transaction in which a U.S. corporation acquired a Canadian corporation.<sup>77</sup>

3.1.2.3. *Fraudulent U.S. Statements Plus U.S. Purchaser Plaintiffs*

The Eighth Circuit found jurisdiction based on the conduct test following letters and telephone conversations in which a Canadian corporation encouraged U.S. citizens not to sell their shares on the open market, but instead to await a future, more favorable tender offer.<sup>78</sup> The promised offer never materialized, and the U.S. plaintiffs were forced to sell on less favorable terms.<sup>79</sup> In its analysis, the *Travis* court noted that of the target company's 2,159,158 outstanding shares, approximately 200,640 shares were owned by 100 U.S. residents, of which plaintiffs owned nearly 80%.<sup>80</sup>

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<sup>75</sup> See *Des Brisay v. Goldfield Corp.*, 549 F.2d 133, 134-36 (9th Cir. 1977).

<sup>76</sup> See *id.*

<sup>77</sup> See *id.* at 135 n.2 (discussing an SEC injunction which resulted in the suspension of trading in shares of a U.S. company).

<sup>78</sup> See *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515, 518-20, 524-26 (8th Cir. 1973).

<sup>79</sup> See *id.* at 519-20.

<sup>80</sup> See *id.* at 519.

3.1.2.4. *Material U.S. Ownership Plus Tender Offer Documents Forwarded to the United States*

In a securities fraud suit by a foreign target against a foreign tender offeror, the Second Circuit found jurisdiction under the effects test where American residents owned 5.3 million shares with a market value of \$120 million, which represented 2.5% of the target's shareholders.<sup>81</sup> The tender offeror knew that U.K. law required British nominees to engage in the conduct of forwarding tender offer documents to U.S. shareholders of the target company and Depository Receipt depository banks in the United States.<sup>82</sup>

3.1.2.5. *Transmission of Orders to the United States Plus Generalized Adverse Effects*

In *Tamari v. Bache & Co. (Leb.) S.A.L.*, an action by foreign citizens against a foreign corporation which was a wholly-owned subsidiary of a U.S. corporation, the Seventh Circuit found jurisdiction using both the conduct and effects tests, even though all communications between the foreign citizens and corporation occurred outside the United States.<sup>83</sup> The court based its conduct test analysis on the transmission of commodities futures orders to the United States for execution.<sup>84</sup> It based its effects test analysis on: the artificial influence on prices and trading volume in the domestic market resulting from fraudulent foreign representations, unauthorized trading or mismanagement of trading accounts, and the possible undermining of public confidence in the markets.<sup>85</sup> The effect on prices, volume, and public confidence relied on by the court, however, appears to be

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<sup>81</sup> See *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 262 (2d Cir.), *modified on other grounds*, 890 F.2d 569 (2d Cir.), *cert. dismissed*, 492 U.S. 939 (1989).

<sup>82</sup> See *id.*

<sup>83</sup> See *Tamari v. Bache & Co. (Leb.) S.A.L.*, 730 F.2d 1103, 1105, 1108 (7th Cir.), *cert. denied*, 469 U.S. 871 (1984).

<sup>84</sup> See *id.* at 1108.

<sup>85</sup> See *id.*

the sort of “unparticularized deleterious effect”<sup>86</sup> that alone would not support subject matter jurisdiction.<sup>87</sup> This suggests that the court may have regarded these effects as additional support for conduct test jurisdiction, rather than regarding them as independent grounds for jurisdiction.

### 3.1.2.6. *Estoppel Rationale*

The Fifth Circuit found no subject matter jurisdiction in *MCG, Inc. v. Great Western Energy Corp.* despite extensive conduct and effects within the United States.<sup>88</sup> Because the decision was based on a narrow estoppel rationale, however, it is not inconsistent with the view that courts implicitly have relied on combined conduct and effects analyses.<sup>89</sup> In *MCG*, a U.S. corporation issued securities that it offered exclusively to non-U.S. citizens.<sup>90</sup> A legend on each stock certificate disclosed the restricted nature of the offer, and, in order to participate in the offering, each purchaser had to sign a declaration of compliance with the restriction.<sup>91</sup> Without the defendant’s knowledge, and contrary to the restriction, the U.S. plaintiffs purchased the stock through a foreign shell created for the purpose of evading the restriction.<sup>92</sup> The court reasoned that after the plaintiffs had structured the transaction to avoid U.S. securities laws, they could not expect to rely on them when the deal soured.<sup>93</sup> It appears likely that these facts would

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<sup>86</sup> *IIT v. Cornfeld*, 462 F. Supp. 209, 223 (S.D.N.Y. 1978) (referring to the *Bersch* court holding that “an unparticularized deleterious effect of the American economy . . . is not sufficient” for finding subject matter jurisdiction under the effects test), *aff’d in part*, 619 F.2d 909, 909 (2d Cir. 1980).

<sup>87</sup> *See, e.g., Cornfeld*, 619 F.2d at 917; *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 989 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

<sup>88</sup> *See MCG, Inc. v. Great W. Energy Corp.*, 896 F.2d 170, 171-73 (5th Cir. 1990).

<sup>89</sup> *See id.* at 175.

<sup>90</sup> *See id.* at 172.

<sup>91</sup> *See id.*

<sup>92</sup> *See id.*

<sup>93</sup> *See id.* at 175; *see also Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1328 (2d Cir. 1972) (leaving undecided the question of subject matter jurisdiction “where the defrauded [U.S.] investor chooses, deliberately and unilaterally, to have the securities

have supported subject matter jurisdiction had the court not applied estoppel.<sup>94</sup>

### 3.2. *Conduct and Effects Decisions Not Combining Elements of Both Tests*

A review of leading decisions which do not combine material elements of both tests reveals that they typically present evidence plainly supporting, or plainly not supporting, the exercise of jurisdiction under a single test. As the evidence in these cases tends to be compelling under one of the two tests, the courts apparently did not feel the need to further justify these decisions by discussing additional facts. These cases represent the decisions at the ends of the conduct-effects spectrum, which runs from pure conduct to mixtures of conduct and effects to pure effects. A summary of these cases follows.

#### 3.2.1. *Effects Test Decisions*

##### 3.2.1.1. *No U.S. Effect Related to Suit*

The Second Circuit found that no subject matter jurisdiction existed where all of the parties involved in a transaction were foreign, even though nonplaintiff U.S. purchasers ultimately acquired some fraudulently issued notes.<sup>95</sup>

##### 3.2.1.2. *Insufficient Ownership by U.S. Residents*

Other cases have held that ownership by U.S. residents of foreign securities through a foreign investment trust may not support subject matter jurisdiction where proportionately few U.S. residents invested in the defrauded trust and the foreign securities represented a small percentage of the investment trust's portfolio. In *IIT v. Vencap, Ltd.*, for example, the Second Circuit held that losses to a foreign

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purchase consummated abroad by a foreigner").

<sup>94</sup> See *Alfadda v. Fenn*, 935 F.2d 475, 477-79 (2d Cir.) (holding that even where sales to U.S. citizens were prohibited and foreign plaintiffs did not violate this restriction, meetings and negotiations in the United States supported assertion of subject matter jurisdiction under the conduct test), *cert. denied*, 502 U.S. 1005 (1991).

<sup>95</sup> See *Fidenas AG v. Compagnie Internationale Pour L'Informatique CII Honeywell Bull*, 606 F.2d 5, 8 (2d Cir. 1979).

investment trust with net assets of \$263 million arising from alleged fraud connected with a \$3 million investment did not support subject matter jurisdiction.<sup>96</sup> Some 300 U.S. investors owned only 0.5% of the trust (worth about \$1.3 million), and shares of the trust were not intended for offer or sale to U.S. citizens.<sup>97</sup>

### 3.2.2. *Conduct Test Decisions*

#### 3.2.2.1. *Fraudulent Omissions*

The Third Circuit has held that fraudulent omissions by a U.S. broker which induced foreign citizens to authorize the purchase of securities issued by a U.S. company traded in the U.S. over-the-counter market support subject matter jurisdiction.<sup>98</sup>

#### 3.2.2.2. *Negotiations and Dilution of Stock*

Negotiations with and sales of stock to a company and an individual in the United States that diluted the foreign plaintiffs' stock ownership in a foreign company support subject matter jurisdiction, even though a prospectus which had represented that the stock would not be diluted had been issued to the foreign plaintiffs outside the United States several years earlier.<sup>99</sup> In this situation, the court found subject matter jurisdiction because it considered conduct within the United States to be more than merely preparatory to the securities fraud; it was considered to have resulted in the consummation of the fraud.<sup>100</sup>

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<sup>96</sup> See *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir.), *on remand*, 411 F. Supp. 1094 (S.D.N.Y. 1975).

<sup>97</sup> See *id.*

<sup>98</sup> See *Straub v. Vaisman & Co.*, 540 F.2d 591, 594-95 (3d Cir. 1976).

<sup>99</sup> See *Alfadda v. Fenn*, 935 F.2d 475, 476-79 (2d Cir.), *cert. denied*, 502 U.S. 1005 (1991).

<sup>100</sup> See *id.* at 478; *cf.* *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1046 (2d Cir. 1983) ("Mere preparatory actions, and conduct far removed from the consummation of the fraud[,] will not suffice to establish jurisdiction.").

### 3.2.2.3. *Promise of Supervision*

The Second Circuit held that mailing a brokerage firm pamphlet from New York, which promised continual supervision by highly qualified managers, and trading futures contracts on U.S. commodities exchanges, were sufficient to support a finding of subject matter jurisdiction.<sup>101</sup> A foreign national filed suit and alleged fraudulent procurement and management of his brokerage account by foreign representatives of a U.S. brokerage firm.<sup>102</sup>

### 3.2.2.4. *Formation of U.S. Partnership to Purchase U.S. Assets*

The Second Circuit has found that conduct within the United States, such as forming a partnership for purchasing real estate, selling shares in the partnership, and misrepresenting the nature of those shares supported subject matter jurisdiction, even though: (1) the partnership essentially was Dutch because all of the parties were Dutch nationals; (2) the parties both initiated and concluded negotiations in the Netherlands; and (3) the purchase agreement called for the application of Dutch law by a Dutch court.<sup>103</sup> The court cautioned that it had found subject matter jurisdiction under these circumstances "by a rather slight margin."<sup>104</sup>

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<sup>101</sup> See *Psimenos*, 722 F.2d at 1043-46. Although the plaintiff in *Psimenos* brought suit under the Commodities Exchange Act, courts have drawn analogies between commodities and securities cases when considering jurisdictional questions. See, e.g., *Miller v. New York Produce Exchange*, 550 F.2d 762, 769 (2d Cir.), cert. denied 434 U.S. 823 (1977).

<sup>102</sup> See *Psimenos*, 722 F.2d at 1043-46.

<sup>103</sup> *AVC Nederland B.V. v. Atrium Inv. Partnership*, 740 F.2d 148, 149-54 (2d Cir. 1984).

<sup>104</sup> *Id.* at 154-55. The court considered "Jurisdiction over Securities Transactions" in the *Restatement (Second) of the Foreign Relations Law of the United States*, in deciding this close case. The *Restatement* provides:

- (1) Any transaction in securities carried out, or intended to be carried out, on a securities market in the United States is subject to United States jurisdiction to prescribe, regardless of the nationality or place of business of the participants in the transaction or of the issuer of the securities.
- (2) As regards transactions in securities not on a securities

### 3.2.2.5. *Foreign Subsidiary Which is Domestic in Substance*

Although the foreign subsidiary of a U.S. company had no operating assets, no substantial foreign operations, and issued securities guaranteed by the U.S. parent, the Second Circuit exercised subject matter jurisdiction over sales of

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market in the United States, but where

- (A) securities of the same issuer are traded on a securities market in the United States; or
- (b) representations are made or negotiations are conducted in the United States in regard to the transactions; or
- (c) the party subject to the regulation is a United States national or resident, or the persons sought to be protected are residents of the United States,

the authority of the United States to exercise jurisdiction to prescribe depends on its reasonableness in the light of evaluation under § 403(2).

RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES, § 416(1)-(2) (Tentative Draft No. 2 1981).

Section 403(2) provides:

Whether the exercise of jurisdiction is unreasonable is judged by evaluating all the relevant factors, including:

- (a) the extent to which the activity (i) takes place within the regulating state, or (ii) has substantial, direct, and foreseeable effect on or in the regulating state;
- (b) the links, such as nationality, residence, or economic activity, between the regulating state and the persons principally responsible for the activity to be regulated, or between that state and those whom the law or regulations is designed to protect;
- (c) the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;
- (d) the existence of justified expectations that might be protected or hurt by the regulation in question;
- (e) the importance of regulation to the international political, legal or economic system;
- (f) the extent to which such regulation is consistent with the traditions of the international system;
- (g) the extent to which another state may have an interest in regulating the activity;
- (h) the likelihood of conflict with regulation by other states.

*Id.* § 403(2). The court found subject matter jurisdiction based on a consideration of §§ 403(2) and 416(2)(b). See *AVC Nederland*, 740 F.2d at 154-55.

the subsidiary's securities to foreigners based on accounting work and the preparation of a prospectus in the United States.<sup>105</sup> Under these circumstances, the court determined that the securities to be domestic "in practical effect."<sup>106</sup>

### 3.2.2.6. *"Essential Core" of Fraud Occurring Outside the United States*

In *Fidenas AG v. Compagnie Int'l Pour L'Informatique CII Honeywell Bull S.A.*, the Second Circuit found that the "essential core" of the alleged fraud took place outside the United States, and that activities in the United States were "secondary and ancillary" to the fraud.<sup>107</sup> The court held that, at best, the activities were "culpable nonfeasance," or being acquainted with an alleged cover-up phase of the fraud.<sup>108</sup> The Second Circuit held that finding subject matter jurisdiction would be inappropriate because the transactions were "predominantly foreign."<sup>109</sup>

### 3.2.2.7. *Meetings and Contract Execution in the United States*

In one decision, the Third Circuit held that defendants' false statements intended to induce a foreign corporation to enter investment contracts with and purchase debentures from two U.S. companies supported subject matter jurisdiction based on significant U.S. conduct related to the defendants' scheme.<sup>110</sup> The significant conduct, defined as "at least some activity designed to further a fraudulent

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<sup>105</sup> See *IIT v. Cornfeld*, 619 F.2d 909, 919-21 (2d Cir. 1980).

<sup>106</sup> *Id.* at 921 n.13; see also *CL-Alexanders Laing & Cruickshank v. Goldfeld*, 709 F. Supp. 472, 477-78 (S.D.N.Y. 1989) (finding subject matter jurisdiction where securities represented obligations of a U.S. corporation and a prospectus mandated that securities would be registered in the United States at a future date, although it prohibited sales to U.S. investors).

<sup>107</sup> *Fidenas AG v. Compagnie Int'l Pour L'Informatique CII Honeywell Bull S.A.*, 606 F.2d 5, 8 (2d Cir. 1979) (involving fraud based on forged promissory notes).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 10 (quoting and affirming lower court opinion).

<sup>110</sup> See *SEC v. Kasser*, 548 F.2d 109, 111-12 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977).



scheme,"<sup>111</sup> consisted of: negotiations; execution of an investment contract; use of the telephone and mails; incorporation of defendant companies or establishment of corporate offices; use of the New York office of a Swiss bank as a conduit for money received from the foreign corporation; maintenance of books and records; drafting of agreements; and transmittal of proceeds.<sup>112</sup>

In another decision, the Eighth Circuit held that execution in the United States of a sales contract for the sale of one foreign company to another foreign company wholly-owned by a Delaware corporation and letters and telephone conversations in which the seller failed to disclose knowledge that the licensor of the seller's primary asset intended to reclaim that asset supported subject matter jurisdiction.<sup>113</sup>

In a case before the Fifth Circuit involving a Ponzi scheme, the court affirmed subject matter jurisdiction where European investors were induced to travel to the United States to inspect various oil wells and mailed signed purchase contracts to the United States, even though the contracts were executed in Europe and the defrauded parties were European.<sup>114</sup>

### 3.2.2.8. *Silence During Meeting*

In *Grunenthal GmbH v. Hotz*, the Ninth Circuit held that the silence of a Swiss citizen where others made false statements about a critical issue involving the Swiss citizen sufficed to support subject matter jurisdiction.<sup>115</sup> The court found subject matter jurisdiction based upon a single U.S. meeting concerning the purchase of one foreign corporation by another.<sup>116</sup> Each of these cases arguably

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<sup>111</sup> *Id.* at 114.

<sup>112</sup> *Id.* at 111.

<sup>113</sup> See *Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 411-13 (8th Cir. 1979).

<sup>114</sup> See *United States v. Cook*, 573 F.2d 281, 282-84 (5th Cir.), *cert. denied*, 439 U.S. 836 (1978).

<sup>115</sup> See *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 422-23, 426 (9th Cir. 1983).

<sup>116</sup> See *id.*

contained adequate evidence to support the jurisdictional decision under one of the two tests, and therefore did not require an extensive discussion of elements relevant to the other test. The focus of these decisions upon one of the two tests is thus not inconsistent with the view that courts implicitly have relied upon elements of both tests when presented with mixed conduct and effect fact patterns in order to achieve a reasonable result.

#### 4. CONCLUSION

*Itoba* is the first decision by a U.S. court of appeals, the Second Circuit, to declare that elements of both the conduct and effects tests should be combined when analyzing subject matter jurisdiction in transnational securities fraud cases. The decision has substantive and procedural significance because disputes over subject matter jurisdiction which follow *Itoba* will focus on *all* the elements of *both* tests. As discussed above, however, *Itoba* can be viewed as part of a natural development in this area of the law which has grown out of increasing judicial experience and the gradual formulation of generally applicable principles. *Itoba* does appear to materially modify existing law.

Under the merged conduct and effects tests, courts will examine a spectrum of activity before deciding the question of subject matter jurisdiction. At the ends of the spectrum are cases involving pure conduct and/or pure effects; in the middle of the spectrum are mixed cases. Courts will exercise subject matter jurisdiction even as the strength of conduct-related facts decreases, as long as there is a corresponding increase in the strength of effects-related facts, and vice versa. In future analyses, U.S. courts likely will combine the factual elements of the leading conduct, effect, and mixed conduct-effects cases to determine whether they should exercise subject matter jurisdiction in future U.S. securities fraud cases.

The decisions discussed herein suggest the following propositions with respect to the future application of the *Itoba* conduct-effects test:

- (1) Attending meetings or engaging in other activities in the United States deemed to be material with

respect to an alleged fraud tends to support subject matter jurisdiction.

(2) The securitization of U.S. assets tends to support the exercise of subject matter jurisdiction even if the securities are sold to foreign entities and individuals in wholly offshore transactions.

(3) The listing of a foreign security on a U.S. exchange and the prerequisite filing of reports with the SEC tend to subject the issuer to the jurisdiction of U.S. courts, if, in addition, there are material purchases by U.S. citizens or material conduct in the United States with respect to an alleged fraud, or both.

(4) Taking no action with respect to encouraging or discouraging the sale of securities to U.S. citizens tends to support the exercise of subject matter jurisdiction if sufficient numbers of U.S. citizens purchase the security in sufficient volume.

(5) Foreign issuers and other participants in the offer and sale of securities tend to fall within the jurisdiction of U.S. courts where: (a) they knew or had reason to know that the issuer's securities would be offered and sold to U.S. citizens; (b) the issuer's securities were sold in material dollar amounts, directly or indirectly, to such citizens; (c) the citizens became plaintiffs; and (d) the plaintiffs alleged fraud adversely impacted the value of those securities.

(6) Prohibiting the sale of an issuer's securities to U.S. citizens and failing to list them on a U.S. exchange tends to inhibit the exercise of jurisdiction, especially where potential purchasers are required to declare that they are not U.S. citizens, and the issuer is not otherwise on notice.

Reliable general rules are difficult to articulate due to the unique facts of each case and the interaction of conduct and effects elements. The above propositions, however, may serve as a useful starting point for evaluating the issue of subject matter jurisdiction in transnational securities fraud cases.